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NO. 84-1944

In The
Supreme Court of the United States
October Term, 1985

UNITED STATES OF AMERICA, ET AL.,
Appellants,

v.

ALVIN HEMME, ET AL.,
Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF ILLINOIS

BRIEF FOR APPELLEES ALVIN HEMME, ET AL.

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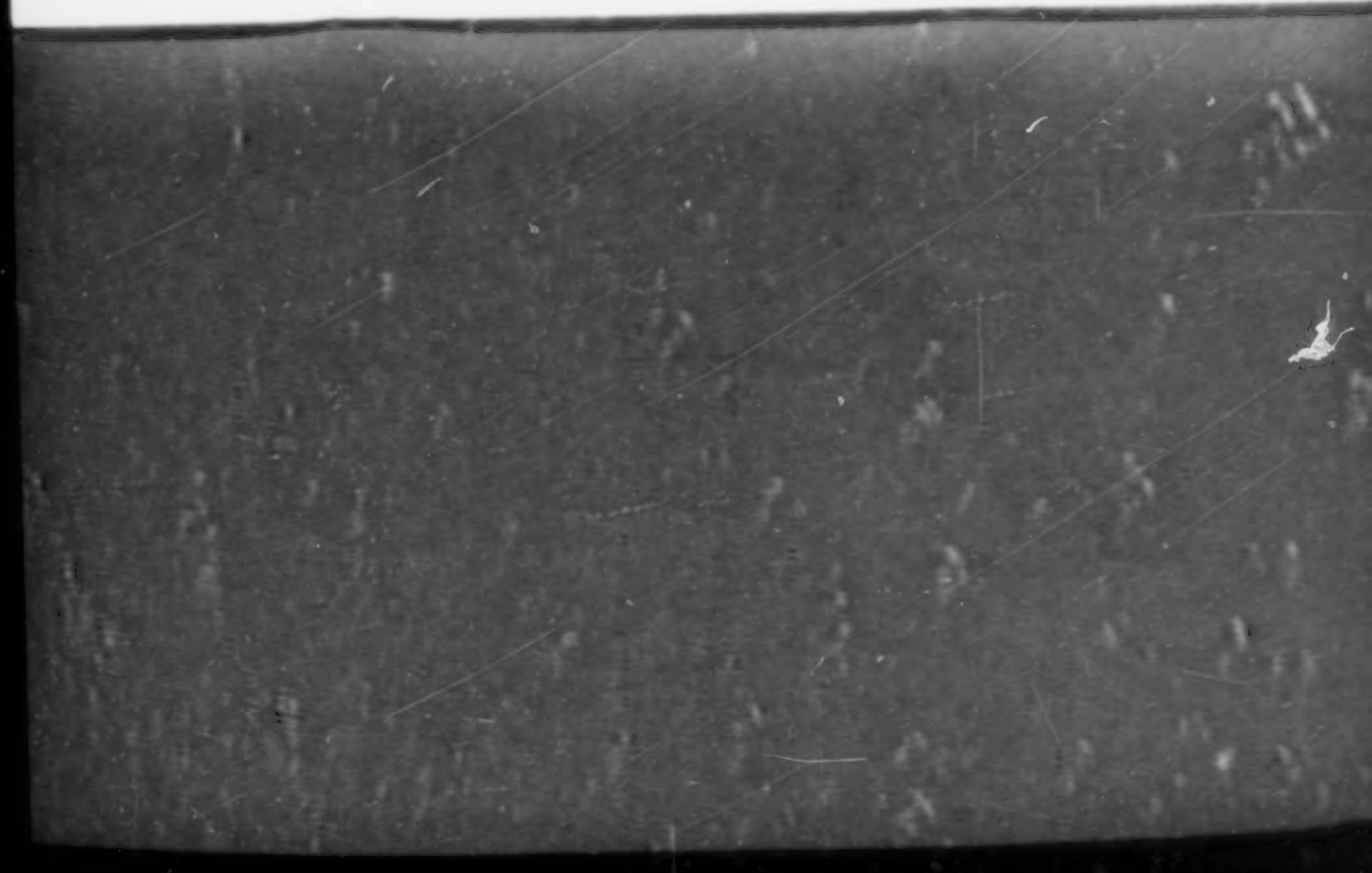

QUESTION PRESENTED

Whether 26 U.S.C. 2010(c) as enacted October 4, 1976, properly construed and constitutionally applied, can reduce the unified credit available under 26 U.S.C. 2010(a) to the estate of a decedent who made gifts after September 8, 1976 and before October 4, 1976, claimed a specific exemption under 26 U.S.C. (1970 ed.) 2521 from application of the gift tax in respect of those gifts, and died within three years of the date of the gifts.

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26 U.S.C. 2010(c), PROPERLY CONSTRUED AND CONSTITUTIONALLY APPLIED, CANNOT REDUCE THE UNIFIED CREDIT AVAILABLE UNDER 26 U.S.C. 2010(a) TO THE ESTATE OF A DECEDENT WHO MADE GIFTS AFTER SEPTEMBER 8, 1976 AND BEFORE OCTOBER 4, 1976, CLAIMED A SPECIFIC EXEMPTION UNDER 26 U.S.C. (1970 ed.) 2521 FROM APPLICATION OF THE GIFT TAX IN RESPECT OF THOSE GIFTS, AND DIED WITHIN THREE YEARS OF THE DATE OF THE GIFTS.	15
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BRIEF FOR ALVIN HEMME, ET AL.

STATEMENT OF THE CASE

A. The Pre-1977 Statutory Framework

Prior to January 1, 1977, the estate tax and the gift tax had separate rate schedules and exemptions. Gift tax rates were set at three-fourths of the estate tax rate for corresponding brackets.[2] The gift tax was cumulative,

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1 A list of all parties to this proceeding is included in Appellee's motion to dismiss.

2 *Cf.* 26 U.S.C. (1970 ed.) 2001 and 26 U.S.C. (1970 ed.) 2502. *See generally* H.R. Rep. 94-1380, 94th Cong., 2d Sess. 10 (1976).

generally taking into account prior gifts to determine the applicable rate at which a gift would be taxed. 26 U.S.C. (1970 ed.) 2502(a). Although the estate tax base did include certain transfers made "in contemplation of death" (26 U.S.C. (1970 ed.) 2035) and other lifetime transfers (e.g., 26 U.S.C. (1970 ed.) 2036), the estate tax did not cumulate lifetime gifts with the value of a decedent's estate to determine the applicable estate tax rates. 26 U.S.C. (1970 ed.) 2001.

The gift tax permitted each taxpayer a lifetime specific exemption of $30,000 (26 U.S.C. (1970 ed.) 2521), and an annual exclusion of $3,000 per donee per year. 26 U.S.C. (1970 ed.) 2503(b). The specific exemption, at the option of the taxpayer, could be claimed in the full amount of $30,000 in respect of a single gift or be spread over a period of time in such amounts as the taxpayer saw fit. Treas. Reg. § 25.2521-1. The estate tax permitted each estate an exemption of $60,000. 26 U.S.C. (1970 ed.) 2052. The exemption from the estate tax was not reduced by a taxpayer's election to claim the taxpayer's specific exemption from the gift tax.

B. H.R. 14844

On August 2, 1976, the House Ways and Means Committee reported H.R. 14844, the Estate and Gift Tax Reform Act of 1976 (H.R. 14844), a comprehensive revision of the gift and estate taxes. H.R. 14844 was designed in part to reduce the estate and gift tax burden on medium sized estates.[3] The Committee found that since the exist-

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[3] The Federal estate and gift taxes significantly increase the progressivity of our tax system and help prevent excessive concentrations of inherited wealth. In fiscal

(Continued on following page)

ing $60,000 estate tax exemption had been enacted in 1942, the percentage of decedents whose estates were subject to tax had increased from one to eight percent. This increase in the percentage of estates subject to tax resulted from inflation and general economic prosperity. H.R. Rep. 94-1380, *supra*, 15. The Committee's proposal was intended to significantly reduce revenue from the estate tax.[4]

The Committee determined that under prior law there was "a substantial disparity of treatment between the

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> year 1977, the estate and gift taxes are expected to raise $5.8 billion, all of which comes from the wealthiest 7 percent of the population.
>
> Despite their important role, the Congress has not made a significant change in the estate and gift taxes since 1948. Estate tax revision is long overdue, and this bill undertakes that task.
>
> The purposes of the Estate and Gift Tax Reform Act of 1976 are to reduce the burden of these taxes on medium-sized estates, to eliminate ways by which estate planners can reduce the estate and gift tax burden through special patterns of transferring their property, to reduce the substantial variations in estate and gift tax burdens that now exist for people with the same amount of wealth, to simplify the administration and settlement of estates and to reduce tax incentives for disposition or retention of assets and the resulting distortions in investment decisions.

H.R. Rep. 94-1380, *supra*, 5.

[4] In fiscal 1977, the then-existing estate and gift taxes were expected to raise $5.8 billion, all from the wealthiest seven percent of the population. H.R. Rep. 94-1380, *supra*, 5. The Committee's bill was expected to reduce estate tax liabilities by $15 million in fiscal 1977, $615 million in 1978, $803 million in 1979, $982 million in 1980, and $917 million in 1981. H.R. Rep. 94-1380, *supra*, 3.

taxation of transfers during life and transfers at death", and designed changes to assure that "the tax burden imposed on transfers of the same amount of wealth should be substantially the same whether the transfers are made both during life and at death or made only upon death." H.R. Rep. 94-1380, *supra*, 11. In the Committee's view, the existing gift and estate tax laws provided a decided preference for lifetime transfers since the gift tax rates were set at three-fourths of the estate tax rates at each corresponding rate bracket. A taxpayer could deflect the future appreciation, if any, associated with the property gifted and incur less tax by transferring property during life rather than at death. Further, since lifetime transfers were not taken into account in determining applicable estate tax rates, a taxpayer's estate was subject to tax under a separate rate schedule starting at the lowest rate. Even had the estate and gift tax rates been identical, the separate rate schedules would have provided a preference for making both lifetime and deathtime transfers rather than having the total transfer subject to one tax under a cumulative rate schedule.[5]

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5 Under present law, there is a substantial disparity of treatment between the taxation of transfers during life and transfers at death. In general, there are three factors which provide a decided preference for lifetime transfers. First, the gift tax rates are set at three-fourths of the estate tax rates at each corresponding rate bracket. Second, lifetime transfers are not taken into account for estate tax purposes and the estate remaining at death is subject to tax under a separate rate schedule starting at the lowest rates. Thus, even if the rates were identical, separate rate schedules would provide a preference for making both lifetime and deathtime transfers rather than having the total

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H.R. 14844 proposed a single unified rate schedule for gift and estate taxes, with progressive rates based on cumulative lifetime and deathtime transfers. The gift tax payable was to be determined by applying the unified rate schedule to the cumulative lifetime taxable transfers and

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transfer subject to one tax. Third, the gift taxes paid are not generally taken into account for either transfer tax base. In the case of a gift, the tax base does not include the gift tax but the payment of the tax results in a decrease in the value of the estate retained by the donor. However, if the property were retained until death, the tax base includes the full value of the property, even though a portion is likely to be required to satisfy estate taxes. Thus, even if the applicable transfer tax rates were the same, the net amount transferred to a beneficiary from a given pre-tax amount of property would be greater for a lifetime transfer solely because of the difference in tax bases.

As a matter of equity, your committee believes the tax burden imposed on transfers of the same amount of wealth should be substantially the same whether the transfers are made both during life and at death or made only upon death. As a practical matter, the preferences for lifetime transfers are available only for wealthier individuals who are able to afford lifetime transfers. The preferences for lifetime transfers are not generally available for those of small and moderate wealth since they generally want to retain their property until death to assure financial security during lifetime. Therefore, your committee believes that the preferences for lifetime transfers principally benefit the wealthy and result in eroding the transfer tax base.

Your committee believes that it is desirable to reduce the disparity of treatment between lifetime and deathtime transfers through the adoption of a single unified estate and gift tax rate schedule providing progressive rates based on cumulative lifetime and deathtime transfers.

H.R. Rep. 94-1380, *supra*, 11-12.

then by subtracting the taxes payable on lifetime transfers made in prior periods. The estate tax payable was to be determined by applying the unified rate schedule to the aggregate of cumulative lifetime transfers made after December 31, 1976 and deathtime transfers, and then by subtracting the gift taxes payable on the lifetime transfers. H.R. Rep. 94-1380, *supra*, 13. In unifying the rate schedules for gift and estate taxes, the Committee intended "to preclude having the same lifetime transfers taken into account more than once for transfer purposes" (H.R. Rep. 94-1380, *supra*, 13), and thereby minimize the disparate treatment accorded gratuitous life and death transfers.

The House Ways and Means Committee also proposed a unified credit against the estate and gift taxes in lieu of the $30,000 gift and $60,000 estate exemptions provided under prior law. The Committee noted that the estate tax exemption was not increased for any portion of the gift tax exemption not used against lifetime transfers, and that since the estate tax exemption had been established in 1942, inflation had eroded the exemption to one-third of its original value. H.R. Rep. 94-1380, *supra*, 15. The Committee's proposal was designed to increase the amount of property which could be transferred free of tax, and to correlate tax-free transfers under the estate tax and the gift tax.

The Committee believed that the estate and gift taxes would be more equitable if the specific exemptions were replaced with a unified credit. At a given level of revenue cost, a tax credit would confer more tax savings on small and medium sized estates; specific exemptions tended to

confer more tax savings on larger estates.[6] Since the gift tax exemption was not, as a practical matter, available to individuals who could not afford to make lifetime transfers, a unified credit would more equally tax transfers without regard to whether the transfers were made only at death or made both during lifetime and at death. H.R. Rep. 94-1380, *supra*, 15-16. In general, any portion of the unified credit used against gift tax would reduce the credit available to be used against the estate tax. Even though the unified credit rules were set forth separately under the estate tax provision and under the gift tax provision, the credit was intended to effect a single unified credit for estate and gift tax purposes. H.R. Rep. 94-1380, *supra*, 16.

H.R. 14844 contained a transitional rule which applied to a taxpayer who benefited from the $30,000 specific exemption from gift tax at any time after June 6, 1932.[7] The Committee, in explaining the transitional rule, stated:

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[6] Since the existing estate tax exemption was a deduction in determining the taxable estate, the exemption reduced each estate's tax at the highest applicable tax bracket. Thus, the larger the estate (and the higher the applicable estate tax bracket), the greater the economic benefit of the specific exemption. A tax credit, on the other hand, would be applied as a dollar-for-dollar reduction of the estate tax otherwise due. See H.R. Rep. 94-1380, *supra*, 15.

[7] Section 2010(c) of H.R. 14844 (set forth at H.R. Rep. 94-1380, *supra*, 94) provided:

> ADJUSTMENT TO CREDIT FOR CERTAIN GIFTS MADE BEFORE 1977—The amount of the credit allowable under subsection (a) shall be reduced by an amount equal to 20% of the aggregate amount allowed in respect of the decedent as a specific exemption under § 2521 (as in effect before its repeal by the Estate and Gift Tax Reform Act of 1976).

> As a transitional rule, the unified credit *allowable* is to be reduced by an amount equal to 20 percent of the amount *allowed* as a specific exemption in computing taxable gifts under present law. Thus, in the case where a donor had *benefited* from the use of the full $30,000 gift tax specific exemption under present law, the maximum unified credit *allowable* would be reduced by $6,000.

H.R. Rep. 94-1380, *supra*, 16 (emphasis added). The Committee equated the phrase "allowed as a specific exemption" with "benefited from the use of the full $30,000 gift tax specific exemption." In view of the unification of the estate and gift taxes proposed by H.R. 14844, a donor would benefit through use of the gift tax exemption only if the gifted assets in respect of which the specific exemption was claimed were not subjected to the unified estate and gift tax in the donor's estate.

C. Conference Report on H.R. 10612, and the Tax Reform Act of 1976

On September 14, 1976 the Conference Committee issued its conference report on the proposed legislation, the Tax Reform Act of 1976 ("Act"). H.R. 10612, the House bill on income tax reform, had not contained revisions to the estate and gift taxes. The Senate had amended H.R. 10612 to include amendments to the estate and gift tax laws. The Conference Committee proposal substantially modified the Senate amendment to the House bill, and adopted many of the provisions contained in H.R. 14844. To the extent that the Conference proposal followed H.R. 14844, "the conferees agree[d] with and incorporate[d] the explanation of those provisions contained in House Re-

port 94-1380 (the Ways and Means Committee Report on H.R. 14844), except as modified in" the conference report. S. Conf. Rep. 94-1236, 94th Cong. 2d Sess. 607 (1976). The Conference Committee's proposal, and the Act as adopted, have been described as flawed, both technically and substantive, in many respects.[8]

H.R. 14844 had proposed a unified credit in lieu of the gift tax and estate tax specific exemptions. The Senate amendment had proposed a credit in lieu of the estate tax specific exemption, but had retained the then existing specific exemption from gift tax. S. Conf. Rep. 94-1236, *supra* 607-8; S. Rep. 94-938, 94th Cong. 2d Sess. (Part 2), 94th Cong. 13 (1976). The Conference agreement generally

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[8] The estate and gift tax amendments focus upon a number of areas which have been of particular concern and which have enjoyed extensive study over the years. Considering this background of concern and study, it is rather surprising that the amendments are so flawed, technically and substantively, in so many respects. The basic reason for this appears to lie in the relatively brief time allowed by Congress for the development of the reform amendments. Too little time was allowed for consideration of policy questions subsidiary to otherwise sound general policy decisions. Disagreements as to certain policy judgments appear to have been precipitously compromised, resulting in distortions of principle. And, too little time was allowed for the effective drafting of statutory provisions which, in any event, would be somewhat complex, but which, in fact, are unusually tortuous and obscure. The upshot is a piece of legislation, presently in effect, which profoundly affects planning for the distribution of wealth, but which is frequently unclear and conceptually inconsistent and which is likely to be modified in a number of substantial respects in the years to come.

J. McCord, *1976 Estate and Gift Tax Reform: Analysis, Explanation and Commentary*, 1-2 (1977).

followed H.R. 14844 with respect to unification of the estate and gift tax rate schedules. Following H.R. 14844, the Conference agreement provided for a unified credit in lieu of the gift and estate tax specific exemptions. In apparent deference to the Senate amendment (which would have retained the $30,000 specific exemption from the gift tax), the conferees agreed that the unified credit was not to be reduced for any amount allowed as a specific exemption for gifts made prior to September 9, 1976.

Section 2010(c) (26 U.S.C. 2010(c)), as reported by the Conference Committee and adopted by the Act, provides the following transitional rule:[9]

> ADJUSTMENT TO CREDIT FOR CERTAIN GIFTS MADE BEFORE 1976—the amount of the credit *allowable* under subsection (a) shall be reduced by an amount equal to 20 percent of the aggregate amount *allowed* as a specific exemption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) with respect to gifts made by the decedent after September 8, 1976. (Emphasis added.)

The transitional rule was apparently designed to limit the benefit of the new unified credit to taxpayers who ex-

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9 The Conference Committee, in describing the transitional rule, stated:

> The unified credit *allowable* is to be reduced by an amount equal to 20 per cent of the amount *allowed* as a specific exemption under present law for gifts made after September 8, 1976, and before January 1, 1977. However, the unified credit is not to be reduced for any amount *allowed* as a specific exemption for gifts made prior to September 9, 1976.

S. Conf. Rep. 94-1236, *supra*, 607-8 (emphasis added).

ploited the specific exemption available for gifts made before January 1, 1977.[10]

D. Facts and Proceedings in this Case

On September 28, 1976 Charles W. Hirschi made gifts to five individuals totalling $45,000. J.A. 6. In a gift tax return filed on September 30, 1976, Mr. Hirschi claimed a specific exemption in the amount of $30,000. J.A. 9. The exemption claimed by Mr. Hirschi served to exempt $30,000 of the gifts from gift tax pursuant to 26 U.S.C. (1970 ed.) 2521. The remaining $15,000 of gifts were ex-

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10 The House Bill would have required reduction of the amount of the unified credit allowed to a taxpayer by an amount equal to 20 percent of any amount claimed by the taxpayer as a specific exemption under Section 2521 of prior law. This provision was based upon the rationale that if a taxpayer had made gifts before the effective date of the new law and had already benefited from the use of the specific exemption, it is appropriate that this prior benefit be taken into account. See H. Rep. at 16.

As ultimately enacted, the reduction of the unified credit for use of the specific exemption is limited to gifts made on and after September 9, 1976, the date the final version of the Act was agreed to by the House and Senate Conferees. It is designed to limit the benefit of the new unified credit in the case of taxpayers who, in anticipation of the new law, may have sought to exploit the specific exemption available for gifts made before January 1, 1977, the effective date of the new law. As enacted, Sections 2010(c) (estate tax) and 2505(c) (gift tax) provide that the amount of the unified credit otherwise allowable to any taxpayer be reduced by 20 percent of the amount allowed as a specific exemption under Section 2521 for gifts made by the taxpayer after September 8, 1976.

J. McCord, *1976 Estate and Gift Tax Reform: Analysis, Explanation and Commentary*, 26 (1977).

cluded from the gift tax by virtue of the $3,000 per donee annual exclusion of 26 U.S.C. (1970 ed.) 2503(b).

Mr. Hirschi died on November 9, 1978, two years, one month and eight days after making the lifetime gifts. His estate filed a federal estate return. The estate included $30,000 of the gifts made on September 28, 1976 and within three years of Mr. Hirschi's death, as required by 26 U.S.C. 2035. In calculating the estate tax due, Mr. Hirschi's estate claimed a unified credit against estate tax in the amount of $34,000, the maximum unified credit then available under 26 U.S.C. 2010(a) without reduction. In auditing the estate tax return, the Internal Revenue Service reduced the $34,000 unified credit claimed by Mr. Hirschi's estate by $6,000 on the authority of 26 U.S.C. 2010(c), given Mr. Hirschi's gifts in the amount of $30,000 during the period from September 8, 1978 to December 31, 1976. J.A. 6. The Internal Revenue Service then concluded that a deficiency existed in the estate tax paid in the amount of $6,000. J.A. 6. In July of 1982, Mr. Hirschi's estate paid the additional tax of $6,000 (J.A. 7), and thereafter instituted the action with respect to which this appeal was taken.

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SUMMARY OF ARGUMENT

The estate and gift tax provisions of the Tax Reform Act of 1976 ("Act") were designed to reduce the estate and gift tax burden on medium-sized estates and, by unifying the estate and gift taxes, to eliminate disparate treatment between the taxation of gratuitous transfers

during life and at death. The Act replaced the estate and gift tax exemptions with a unified credit against both estate and gift taxes. Since the Act was adopted on October 4, 1976 and was to be generally effective January 1, 1977, Congress was apparently concerned that a taxpayer would, after learning of the Act, benefit from the $30,000 specific exemption from the gift tax during the transition period, and also be able to use the full unified credit available under the Act. Congress sought to preclude a taxpayer from benefiting under the specific exemption during the transition period and the full unified credit after the effective date of the Act by adopting the transitional rule in 26 U.S.C. 2010(c).

The Government urges that since Mr. Hirschi made gifts of $30,000 on September 28, 1976 and claimed his $30,000 specific exemption from gift tax against such gifts, Mr. Hirschi's estate must reduce the available unified credit by $6,000 even though his estate included and paid tax on the $30,000 of gifted assets in respect of which the specific exemption was claimed. The harsh result urged by the Government is not "consistent with either the letter or intent of the relevant provisions of the [Internal Revenue] Code." *Gladney v. Commissioner*, 54 U.S.L.W. 3268 (October 22, 1985) (O'Connor, J., dissenting from denial of certiorari). Section 2010(c) provides for a reduction of the unified credit only where the specific exemption has been allowed with respect to a gift during the transitional period. Congress intended that the unified credit be reduced only where the donor had benefited through use of the donor's specific exemption. Although Mr. Hirschi claimed a $30,000 specific exemption in respect of the September 28, 1976 gifts, the exemption was

not finally allowed under the unified estate and gift tax structure. When the gifts were included and taxed in Mr. Hirschi's estate, Mr. Hirschi's claimed $30,000 specific exemption was effectively disallowed. Accordingly, neither Mr. Hirschi nor his estate received a benefit from the exemption within the meaning of the transitional rule. Section 2010(c), construed in harmony with the scheme and general purposes of the Act, should not be applied to reduce the unified credit available to Mr. Hirschi's estate.

As applied to Mr. Hirschi's estate, Section 2010(c) imposes a retroactive penalty tax upon Mr. Hirschi's exercise of his statutory right to claim a specific exemption from tax, even though Mr. Hirschi ultimately received no benefit from his claim to his specific exemption. Mr. Hirschi made the gifts and claimed his specific exemption prior to October 4, 1976, the adoption date of the Act. At the time Mr. Hirschi exercised his right to claim his specific exemption, his claim to the specific exemption may have decreased, but could not have increased, the estate taxes ultimately payable by his estate. Since Mr. Hirschi's gifts were included and taxed in his estate, application of Section 2010(c) to reduce the unified credit available to his estate is unnecessary to prevent Mr. Hirschi and his estate from receiving a double tax benefit. Section 2010(c), as applied to Mr. Hirschi's estate, arbitrarily ignores Mr. Hirshi's right, in effect when Mr. Hirschi made the gifts, to make up to $30,000 in gifts, claim an exemption from gift tax, and suffer no possible increase in estate tax by virtue of the claimed exemption.

ARGUMENT

26 U.S.C. 2010(c), PROPERLY CONSTRUED AND CONSTITUTIONALLY APPLIED, CANNOT REDUCE THE UNIFIED CREDIT AVAILABLE UNDER 26 U.S.C. 2010(a) TO THE ESTATE OF A DECEDENT WHO MADE GIFTS AFTER SEPTEMBER 8, 1976 AND BEFORE OCTOBER 4, 1976, CLAIMED A SPECIFIC EXEMPTION UNDER 26 U.S.C. (1970 ed.) 2521 FROM APPLICATION OF THE GIFT TAX IN RESPECT OF THOSE GIFTS, AND DIED WITHIN THREE YEARS OF THE DATE OF THE GIFTS.

A. The Transitional Rule Incorporated In 26 U.S.C. 2010(c), Properly Construed, Does Not Reduce the Unified Credit Otherwise Allowable to Mr. Hirschi's Estate.

This Court typically "will not pass on the constitutionality of an Act of Congress if a construction of the statute is fairly possible by which the question may be avoided." *United States v. Clark*, 445 U.S. 23, 27 (1980). Since both a constitutional issue and an issue of statutory construction were raised before the district court, this Court is not foreclosed from considering the statutory question merely because the district court failed to address it. *Clark*, *supra* at 27.

"The starting point in every case involving construction of a statute is the language itself." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J. concurring). The Act introduced a unified credit to be applied against both the gift tax and the estate tax. 26 U.S.C. 2010 and 2505. Section 2010(c) of the Code, as contained in the Act, provided that the unified credit:

> * * * shall be reduced by an amount equal to 20 percent of the aggregate amount *allowed* as a specific exemption under § 2521 (as in effect before its repeal by the Tax Reform Act of 1976) with respect to gifts made by the decedent after September 8, 1976. (Emphasis added.)

Although Mr. Hirschi, in his gift tax return filed on September 30, 1976, claimed his $30,000 specific exemption with respect to his gifts, his specific exemption was, in effect, never allowed. Upon Mr. Hirschi's death within three years of the gifts, the gifts were included and taxed in Mr. Hirschi's estate. The transitional rule reducing the unified credit in certain instances was intended to apply "where a donor had *benefited* from the use of the * * * gift tax specific exemption." H.R. Rep. 94-1380 *supra*, 16 (emphasis added). Mr. Hirschi's claim of the $30,000 specific exemption would have benefited Mr. Hirschi only if he had survived three years from the date of the gift and the gifts were not included in his estate. Since Mr. Hirschi died within three years of the date of the gifts, the gifts were included in his estate, and subjected to estate taxes.[11]

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[11] Appellees acknowledge that if Hirschi had survived three years after September 28, 1976, and if the Internal Revenue Service had not disallowed Hirschi's claimed exemption within three years of the filing of Hirschi's gift tax return, the unified credit otherwise allowable to Hirschi's estate under 26 U.S.C. § 2010(a) would have been reduced by $6,000 pursuant to 26 U.S.C. § 2010(c). Thus, the taxpayers who would benefit from a ruling against the Government is a closed class of taxpayers who made gifts between September 8, 1976 and October 4, 1976, the date of the enactment of the Act, claimed all or a portion of the $30,000 specific exemption in respect of those gifts, and died within three years of making those gifts.

The Government's contention is that Mr. Hirschi's election to claim his $30,000 specific exemption in respect of the September 28, 1976 gifts forces a reduction of his unified credit under 26 U.S.C. 2010(c).[12] To the contrary, the statute clearly provides for the unified credit to be reduced "by an amount equal to 20 percent of the aggregate amount allowed as a specific exemption under § 2521". 26 U.S.C. 2010(c). In construing tax statutes, "it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used * * *. In case of doubt they are to be construed most strongly against the Government, and in favor of the citizen." *Gould v. Gould*, 245 U.S. 151, 153 (1917).

The fact that Mr. Hirschi claimed his $30,000 specific exemption does not meet the statutory threshold for reduction of the unified credit. To reduce the amount of unified credit, the specific exemption must have been not only claimed, but allowed. While the parties stipulated that Mr. Hirschi had elected to apply the specific exemption of $30,000 (J.A. 5), the record does not reflect that the specific exemption was allowed by the Internal Revenue Service. Moreover, Mr. Hirschi's claimed specific exemption was not finally allowed as of Hirschi's death

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[12] The parties stipulated in the district court that:

> The sole issue to be decided herein is whether the decedent's *election* to apply the $30,000 specific exemption against the taxable gifts made on September 28, 1976 results in a $6,000 reduction of the unified credit pursuant to Internal Revenue Code § 2010(c), where the gifts were included in the decendent's gross estate, for estate tax purposes, pursuant to Internal Revenue Code, Section 2035.

J.A. 7 (emphasis added).

on November 9, 1978.[13] Mr. Hirschi's claim to his $30,000 specific exemption was effectively disallowed by the inclusion of the $30,000 gifted assets in his estate for Federal estate tax purposes. Under our federal tax system, "'[a]llowed' connotes a grant."[14] *Virginian Hotel Corp. v. Helvering*, 319 U.S. 523, 527 (1942). Since Mr. Hirschi's gifts were included and taxed in his estate, Mr. Hirschi was granted no benefit by virtue of his claim to a specific exemption, and his claim was never "allowed".

This Court has noted that "[t]he true meaning of a single section of this statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history

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13 The Service could have disallowed Mr. Hirschi's claimed specific exemption and assessed a deficiency with respect to Mr. Hirschi's gift tax return at any time within three years after the return was filed, or until more than ten months after Mr. Hirschi's death. 26 U.S.C. 6501.

14 The Court in *Virginian Hotel Corp.* proceeded to discuss that with respect to income taxes:

> Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are "allowed," since tax liability is then determined on the basis of the returns. Apart from contested cases, it is indeed the only way in which deductions are "allowed."

319 U.S. at 527. Unlike the income tax system, the scheme of the unified gift and estate taxes automatically disallows any claim to a specific exemption from gift tax when the gifted assets are included in and taxed in the donor's estate.

of the income tax legislation of which it is an integral part." *Commissioner v. Engle*, 464 U.S. 206, 78 L.Ed.2d 420, 433 (1983). In construing 26 U.S.C. 2010(c), this Court should apply "that interpretation which can most fairly be said to be imbedded in the statute, in the sense of being most harmonious with its scheme and with the general purposes that Congress manifested." *Commissioner v. Engle*, supra, 78 L.Ed.2d at 429 (1983), quoting *NLRB v. Lion Oil Co.*, 352 U.S. 282, 297 (1957) (Frankfurter, J., concurring in part and dissenting in part). Interpretations of the statute "which would produce absurd results are to avoided if alternative interpretations consistent with the legislative purpose are available". *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 575 (1982). Tax statutes "should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences". *Farmers Loan & Trust Company v. Minnesota*, 280 U.S. 204, 212 (1930).

The Government interprets 26 U.S.C. 2010(c) as a punitive measure designed to reduce the unified credit available to any donor claiming a specific exemption with respect to gifts made between September 8, 1976 and October 4, 1976, even if the donor did not benefit from the claimed exemption. If Mr. Hirschi had made the gifts and claimed his specific exemption prior to September 8, 1976, his gifts and claim of exemption would not have reduced the old estate tax exemption or the new unified credit,

whichever was in effect as the time of his death.[15] If Mr. Hirschi had waited to make his gifts until after December 31, 1976, the unified credit allowable to Mr. Hirschi's estate would not have been reduced by virtue of Mr. Hirschi's lifetime transfers.[16] The Act's legislative history does not suggest that Congress intended to alter this established policy by punishing donors who attempted to gift property during their lifetime. Rather, Congress intended to assure that "the tax burden imposed on transfers of the same amount of wealth should be the same whether the transfers are made both during life and at death or made only upon death." H.R. Rep. 94-1380, *supra*, 11.

Congress further intended "to preclude having the same lifetime transfers taken into account more than once

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[15] Under the tax statutes as in effect prior to the Act, a donor was entitled to a specific exemption of $30,000 from the gift tax, and the donor's estate would be entitled to an unreduced exemption of $60,000 from the estate tax. A specific exemption from the gift would not have reduced or impaired his estate's right to exempt $60,000 from the estate tax. 26 U.S.C. (1970 ed.) 2052. Even under the Government's interpretation of 26 U.S.C. 2010(c), the unified credit would not be reduced in respect of gifts made prior to September 9, 1976.

[16] If Mr. Hirschi had made the gifts after December 31, 1976 and died on November 8, 1978, the gifts would have been included in Mr. Hirschi's estate. 26 U.S.C. 2035. Although estate taxes owed by the estate would have, in effect, included tax attributable to the value of the lifetime transfers (see 26 U.S.C. 2001(b)), the amount of unified credit available to Mr. Hirschi's estate would not have been reduced by virtue of Mr. Hirschi's having claimed a portion of the unified credit in respect of the lifetime gifts (26 U.S.C. 2010). "[T]he credit is in effect a single unified credit for estate and gift tax purposes." H.R. Rep. 94-1380, *supra*, 16.

for transfer tax purposes". H.R. Rep. 94-1380, *supra*, 13. The Government's interpretation of § 2010(c) would, in effect, take Mr. Hirschi's gifts into account for both the gift tax and the estate tax. Mr. Hirschi's gifts were included and taxed in his estate. The only rationale for applying Section 2010(c) to reduce the unified credit available to Mr. Hirschi's estate is that Mr. Hirschi benefited from his claim to the specific exemption in respect of the gifts. If Mr. Hirschi benefited from his claim to the exemption, then the gifted assets are taken into account for gift tax purposes as well as estate tax purposes, contrary to Congress' intent that lifetime transfers be subjected to only one transfer tax.

The Government relies heavily on the Court of Claims' decision in *Estate of Renick v. United States*, 687 F.2d 371 (Ct.Cl. 1982). In *Renick*, the taxpayer made a gift of $100,000 two months after the enactment of Section 2010(c) rather than on September 28, 1976, the date of Mr. Hirschi's gifts which was made more than one week before October 4, 1976, the date the President signed the Act. The Court of Claims, in construing the statute, mischaracterized the most material provision of Section 2010(c).[17] In seeking to ascribe the "plain meaning" to Section 2010(c) the Court of Claims concluded that:

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[17] The Government had itself misquoted 26 U.S.C. Section 2010(c) in its Brief before the Court of Claims:

> The credit was to be phased in over a five-year period, beginning at $30,000 for the calendar year 1977, and rising to $47,000 for the calendar year 1981 and years thereafter. However, the total allowable credit was to be "reduced by an amount equal to 20 percent of the aggregate amount *allowable* as a specific exemption" with respect to gifts made after September 8, 1976, and before January 1, 1977. Section 2010(c).

Brief for the United States in Support of its Cross Motion on the Pleadings and in Opposition to Plaintiffs' Motion for Judgment on the Pleadings at 6-7 (Emphasis added), *Renick*, *supra*.

> The plain language and legislative design of § 2010(c) show that Congress intended the reduction to the unified credit to occur in all cases where gifts were made during the transition period and the specific gift tax exemption of $30,000 *allowable* under prior law, or any part thereof, was taken by the donors. The court cannot imply an exception to the statute merely because it would be more reasonable or more equitable to do so. Any such change or modification of 2010(c) must be left to Congress. (687 F.2d at 376 (emphasis added)).

The plain language of Section 2010(c), of course, provides for the unified credit to be reduced by an amount equal to 20 percent of the "aggregate amount *allowed* as a specific exemption under section 2521." Section 2010(c) (emphasis added).

The Court of Claims in *Renick*, following a cursory examination of the Act and its legislative history, erroneously concluded that at the time the decedent made the gift, "it appeared that he would benefit from the $30,000 exclusion". 687 F.2d at 377. The Act's scheme and general purpose were designed to unify the estate and gift taxes. Whether or not a donor ultimately benefited by virtue of a claimed specific exemption could not be determined until the earlier of the donor's death or the passage of three years from the date of the gift. If the donor made a gift which was ultimately included in the donor's taxable estate, the donor would receive no benefit from the claimed specific exemption under the unified estate and gift tax system. In holding that the tentative receipt of a benefit is equal to the actual receipt of the benefit, the Court of Claims ignored the scheme and general purposes that Congress manifested in adopting the Act.

The Government contends that the situation in which Appellees find themselves is not "inequitable" (Government's Brief, p. 16), or even if "inequitable", that such "inequity stems, not from the Internal Revenue Code, but from the fact of human mortality." (Government's Brief p. 17). The opposite is true. If Mr. Hirschi had made the gifts and not claimed his specific exemption but paid the $2,250 in gift tax that would then have been due, his estate would have had credited against the estate tax the $2,250 in gift tax paid (26 U.S.C. 2012) and would have enjoyed the full $34,000 in credit if he died within three years from the date of his gift. Thus, under the Government's interpretation, Mr. Hirschi caused his estate to pay more tax than his estate would have paid had he not claimed his $30,000 specific exemption. But, in unifying the estate and gift taxes, Congress intended to impose the same overall taxes whether the transfers were made both during life and at death or only at death.

The Government apparently urges that the Committee report which read as follows with respect to the transitional rule:

> As a transitional rule, the unified credit *allowable* is to be reduced by an amount equal to 20 percent of the amount *allowed* as a specitic exemption in computing taxable gifts under present law. Thus, in the case where a donor had *benefited* from the use of the full $30,000 gift tax specific exemption under present law, the maximum unified credit *allowable* would be reduced by $6,000.

(H.R. Rep. 94-1380, (emphasis added)), should have read as follows:

> As a transitional rule, the unified credit *allowable* is to be reduced by an amount equal to 20 percent of the

amount *allowable* as a specific exemption in computing taxable gifts under present law. Thus, in the case where a donor had *claimed* the use of the full $30,000 gift tax specific exemption under present law, the maximum credit *allowable* would be reduced by $6,000 *even if the property which was the subject of the claimed $30,000 gift tax specific exemption is subsequently included in the donor's estate by reason of the application of Code Section 2035 or other applicable section.* (Emphasis added.)

The treatment accorded split gifts by Congress under the Act further illustrates that the harsh result urged by the Government is contrary to the intent of the Act. Under the split gift provision of the Act, the spouse of a donor may treat the gift as though the donor had given away half of the property and the donor's spouse had given away the other half. 26 U.S.C. 2513. This optional gift splitting privilege effectively doubles the gift tax exclusions and credits and thus permits the gift to be taxed in a lower bracket. If upon the death of the actual donor the property transferred is included in the actual donor's estate, a question arises as to the treatment of the specific exemption under prior law or unified credit claimed by the surviving spouse in connection with the split gift. This question was specifically disposed of under the Act in a fashion not to penalize the estate of either the actual donor or the consenting spouse.[18]

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[18] The Act did not substantially change prior law. If a gift made by a decedent is includible in the decedent's gross estate, the full amount of the gift is included, even though at the time the gift was made the decedent's spouse consented to treat the gift as made one-half by each spouse. Thus, 26 U.S.C. 2513 is viewed as providing a method for

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For purposes of computing the gift tax payable with respect to gifts subsequently made by the consenting spouse, 26 U.S.C. 2503 mandates the forfeiture of such credit. Thus, under 26 U.S.C. 2505(a), the consenting spouse's unified gift tax credit for future gifts will be reduced by any credit "allowable" against prior gifts, even including split gifts. 26 U.S.C. § 2505(a). The House explanation of 26 U.S.C. 2001(d) specifies the same result:

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computing the gift tax, and has no bearing on whether a gift actually made by the decedent during the decedent's life may be included in the decedent's gross estate. See Rev. Rul. 54-246, 1954-1 C.B. 179.

Under prior law, if the consenting spouse claimed the $30,000 specific exemption against the one-half portion of a split gift attributed to the consenting spouse, and if such exemption was allowed, the amount of the exemption thus claimed and allowed would not be restored for any future gift made by the consenting spouse, even though the split gift was fully included in the estate of the deceased spouse. *Ingalls v. Commissioner*, 40 T.C. 751 (1963), *aff'd*, 336 F.2d 874 (4th Cir. 1964).

26 U.S.C. 2001(d), quoted in the following paragraph, mandates this same treatment under the Act. Inclusion of the full value of the split gift in the estate of the actual donor is assumed and the allowance of the gift tax liability imposed upon the one-half portion attributable to the consenting spouse as a tax payable credit against the tentative estate tax of the decedent-donor is provided.

(d) ADJUSTMENT FOR GIFT TAX PAID BY SPOUSE—For purposes of subsection (b)(2), if—

(1) the decedent was the donor of any gift one-half of which was considered under section 2513 as made by the decedent's spouse, and

(2) The amount of such gift is includible in the gross estate of the decedent, any tax payable by the spouse under chapter 12 on such gift (as determined under section 2012(d)) shall be treated as a tax payable with respect to a gift made by the decedent.

> In addition, the gift tax paid by a spouse is to be a subtraction, or offset, in computing the estate tax imposed where the transfer subject to the tax is included in the decedent's gross estate and was considered to have been a transfer made in part by the surviving spouse under the gift-splitting provisions of present law. The effect of this treatment is to reverse the consequences of having treated the surviving spouse as the donor of one-half of a gift made to a third party for gift tax purposes where the property transferred is subsequently included in the decedent's gross estate. *However, there is to be no restoration of any portion of the unified credit used against gift taxes paid by the surviving spouse. (This treatment is similar to court decisions reached under present law which do not permit restoration of any portion of the gift tax exemption used with respect to a transfer which is later included in the other spouse's estate because it was made in contemplation of death.)*

H.R. Rep. 94-1380, *supra*, 13. (emphasis added). In contrast to the Committee comments relating to Section 2010(c), the Committee expressly provided that the unified credit was not to be restored in this split gift situation.

Although no portion of the consenting spouse's unified gift tax credit is thereafter restored, the adverse effect resulting from such spouse's consent to split-gift treatment is corrected by means of an estate tax computation. In computing the tentative estate tax of a consenting spouse, there is excluded from the amount of the consenting spouse's adjusted taxable gifts the amount of the gifts that were included in the donor spouse's estate.[19] Moreover, in computing the final estate tax, the gift tax

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[19] *See* 26 U.S.C. 2001(b) and (c).

paid by the consenting spouse is not allowed as part of the gift tax offset on the consenting spouse's estate tax return to the extent that the offset had been used on the donor spouse's estate tax return by reason of the application of 26 U.S.C. 2001(d). Thus, if the credit is forfeited, the amount of the gift against which such credit was applied is removed from the estate of the consenting spouse.

The Government contends for the contrary with respect to Mr. Hirschi: Mr. Hirschi's unified credit must be reduced, *and* the gifts causing the reduction of his credit must be included in his estate.

B. The Transitional Rule, if Applied to Reduce the Unified Credit Otherwise Allowable to Mr. Hirschi's Estate, is a Retroactive Tax Imposed Upon Mr. Hirschi's Exercise of His Right to Claim a Specific Exemption, and is Arbitrary, Capricious and Constitutionally Invalid.

Consistent with the holding of the district court, 26 U.S.C. 2010(c) as applied to Mr. Hirschi and his estate is unconstitutionally arbitrary and capricious and an unfair trap for the wary.[20] Mr. Hirschi made gifts on September 28, 1976, and claimed his $30,000 specific exemption by timely filing his gift tax return reflecting the gifts. At the time Mr. Hirschi claimed the specific exemption, his

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[20] Appellants assert that "Contrary to the District Court's statement (J.S. App. 3a), Section 2010(c) as applied to Appellees does not constitute 'retroactive' legislation . . . ." (Appellants' Brief, p. 18.) In fact, the District Court held as follows:

> Accordingly, we hold that the tax under Section 2010(c) as applied to this transaction is so arbitrary and capricious as to render it unconstitutional. (J.S. App. p. 6a.)

claim to the specific exemption could not have increased the amount of tax ultimately payable by his estate. Given his death two years, one month and eight days later, his September, 1976 gifts became subject to the estate tax and his otherwise available $34,000 unified credit was reduced by 20% of the $30,000 specific exemption claimed. Thus, the amount of his estate tax was increased by $6,000, even though he received no benefit from his claim to his specific exemption from gift tax. Section 2010(c), if applied to Mr. Hirschi's estate, imposes a tax upon Mr. Hirschi's exercise of his right to claim the specific exemption. No rational legislative purpose supports the retroactive imposition of a tax upon a taxpayer's claim to his statutorily allowed specific exemption.

"The touchstone of due process is protection of the individual against arbitrary action of government***." *Wolff v. McDonnell*, 418 U.S. 539, 558 (1974). The Due Process clause of the Fifth Amendment "bars Congress from enactments that shock the sense of fair play." *Galvan v. Press*, 347 U.S. 522, 530 (1953). This Court has recognized that due process applies to prevent Congress, through a seeming exercise of the taxing power, from arbitrarily confiscating property through gross and patently inequitable classifications.[21] *Brushaber v. Union*

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21 So far as the due process clause of the Fifth Amendment is relied upon, it suffices to say that there is no basis for such reliance since it is equally well settled that such clause is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, that the Constitution does not conflict with itself by conferring upon the one hand a taxing power and

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Pacific R.R. Co., 240 U.S. 1 (1916). "[A] statute purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the 5th Amendment." *Nichols v. Coolidge*, 274 U.S. 531, 542 (1927). In *Blodgett v. Holden*, 275 U.S. 142, (1927), modified 276 U.S. 594 (1928), this Court held the Revenue Act of 1924, insofar as it undertook to impose a tax on gifts made prior to the effective date of the act, was arbitrary and invalid under the Due Process clause because:

> [i]t seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing.

275 U.S. at 147. Further, in *Untermyer v. Anderson*, 276 U.S. 440 (1928), this Court held that the Revenue Act of 1924, even as applied to gifts made while the act was pending before Congress, was arbitrary and invalid:

> The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage

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> taking the same power away on the other by the limitations of the due process clause. And no change in the situation here would arise even if it be conceded, as we think it must be, that this doctrine would have no application in a case where although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality inevitably lead to the same conclusion.

Brushaber v. Union Pac. R.R. Co., 240 U.S. 1, 24-5 (1916) (citations omitted).

> of progress through Congress we think is not enough to differentiate this cause from the former one and to relieve the legislation of the arbitrary character there ascribed to it. To accept the contrary view would produce insuperable difficulties touching interpretation and practical application of the statute, and render impossible proper understanding of the burden intended to be imposed. The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not expressed until final action thereon has been taken.

276 U.S. at 445-46.[22] "Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process." *Welch v. Henry*, 305 U.S. 134, 147 (1938).

Statutory classifications are generally valid if they bear a rational relation to a legitimate governmental purpose. *See e.g. Harris v. McRae*, 448 U.S. 297, 322 (1980). Congress has broad latitude in creating classifications and distinctions in tax statutes. *Regan v. Taxation with Representation*, 461 U.S. 540, 547 (1983). "Traditionally classification has been a device for fitting tax programs

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[22] In *Untermyer v. Anderson*, 276 U.S. 440 (1928), this Court held that the Revenue Act of 1924, 43 Stat. 313-15, as applied to gifts made before the date of enactment was unconstitutional because it was so unfair and arbitrary that it violated the due process clause of the Fifth Amendment. The holding in *Untermyer* has been limited by this Court to a "new tax" rather than to additions to an existing tax, *United States v. Darusmont*, 449 U.S. 292 (1981).

to local needs and usages in order to achieve an equitable distribution of the tax burden." *Regan, supra,* 547, citing *Madden v. Kentucky,* 309 U.S. 83 (1940). The test of validity of tax statutes in respect of due process is whether the means adopted is appropriate to the end. "[I]f the means are unnecessary or inappropriate to the proposed end, are unreasonably harsh or oppressive, when viewed in light of the expected benefit, or arbitrarily ignore recognized rights to enjoy or to convey individual property, the guaranty of due process is infringed." *Helvering v. City Bank Farmers Trust Co.,* 296 U.S. 85, 90 (1935).

The only purpose suggested by the Government for the transitional rule contained in Section 2010(c) is to prevent a taxpayer and his estate who had claimed the specific exemption under 26 U.S.C. (1970 ed.) 2521 from deriving a double tax benefit from an unreduced unified credit under 26 U.S.C. 2010, in addition to the benefit afforded by the taxpayer's use of the taxpayer's specific exemption. Government's Brief 12. As applied to Mr. Hirschi's estate the transitional rule is overbroad, since inclusion of Mr. Hirschi's gifts in his estate prevented any double tax benefit. To the extent Section 2010(c) applies to reduce the unified credit otherwise allowable to Mr. Hirschi's estate, Section 2010(c) imposes a retroactive penalty tax upon Mr. Hirschi's estate because Mr. Hirschi exercised his right to claim a specific exemption even though Mr. Hirschi ultimately received no benefit from his claim to the exemption. The transitional rule is unreasonably harsh and oppressive, and arbitrarily ignores Mr. Hirschi's recognized right, in effect at the time Mr. Hirschi made the gifts, to make up to $30,000 in gifts, claim an exemption from gift taxes in respect of those gifts, and

suffer no potential increase in estate tax by virtue of the claimed exemption.

The application of 26 U.S.C. 2010(c) to reduce the unified credit available to Mr. Hirschi's estate results, in effect, in double taxation of Mr. Hirschi's gifts.[23] At the time Mr. Hirschi made the gifts, no portion of the gifts were subject to the gift tax by reason of the application of Mr. Hirschi's $3,000 per year per donee annual exclusion (26 U.S.C. (1970 ed.) 2503(b)) and his $30,000

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[23] In Appellee's claim for refund, they assert:

> It is the position of this estate that it was not the intention of the drafters of the Internal Revenue Code that both the amount of the gift be included in the estate and the unified credit be reduced by 20% of the pre-1977 specific exemption under Section 2010(c), but it was the intention of the drafters of the Internal Revenue Code that in the event of the occurrences which are involved in this case, the gross estate would include all of the gift in contemplation of death and the unified credit against estate tax would not be reduced by 20% of the pre-1977 exemption.
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> *In essence,* such inequitable treatment results in double taxation. Section 2010 allows a unified credit for every estate against the tax imposed by Section 2001 . . .

J.A. 21 (emphasis added).

and that

> Section 2001 provides for a 34% rate of tax upon the top bracket of the estate of Charles Hirschi. The tax imposed by Section 2001 is calculated upon the gross estate which includes, under Section 2035, the transfers made on September 28, 1976. Through the process of inclusion of these transfers in the gross estate, and a reduction in the allowable unified credit, *the effect* results in a doubling of the 34% rate of tax. Furthermore, there is no statute which provides for Section 2035 inclusion and double taxation.

J.A. 22 (emphasis added).

specific exemption (26 U.S.C. (1970 ed.) 2521). Further, at the time Mr. Hirschi made the gifts and claimed the specific exemption, the claim of exemption would not have increased the estate taxes payable by Mr. Hirschi's estate. To the extent Section 2010(c) applies to reduce the unified credit available to Mr. Hirschi's estate, Section 2010(c) effectively imposes a retroactive penalty tax upon Mr. Hirschi's claim to the specific exemption. Unlike the situation presented in *Milliken v. United States*, 284 U.S. 15 (1931), Section 2010(c), if applied to Mr. Hirschi's estate, imposes a totally new and different tax upon Mr. Hirschi's gifts and claim to his statutory specific exemption. Mr. Hirschi's otherwise available unified credit was reduced by $6,000. Thus, upon his death, Mr. Hirschi's estate would pay $6,000 more in tax than would otherwise have been payable but for Mr. Hirschi's gifts and claim to his specific exemption during the transitional period.

In general, a statute which reaches back to attach new legal rights and duties to an already completed transaction is retroactive. *Forbes Pioneer Boat Line v. Board of Comm'r of Everglades Drainage District*, 258 U.S. 338, 339-40 (1922). The clearest form of retroactive legislation gives pre-enactment conduct a different legal effect from that which it would have had without the passage of the legislation. *See generally*, Cooley, *The Limits to Legislative Power in the Passage of Curative Laws*, 12 Cent. L.J. 2 (1881). Retroactive legislation has traditionally been regarded as undesirable for several reasons: it infringes upon an individual's desire to plan conduct without surprise, with reasonable certainty and free from the "fluctuating policy" of the legislature (The Federalist No. 44, at 279 (Lodge ed. 1888) (Madison)); and it eliminates

reasonable certainty as to past transactions. Moreover, while a court's pronouncement may apply to past conduct, a legislature's function is, in general, to declare law for the future. *See generally*, Smead, *The Rule Against Retroactive Legislation: A Basic Principle of Jurisprudence*, 29 Minn. L. Rev. 775, 789 (1936).

In the income tax area, uniformly and fairly applied retroactive legislation predominates, though blurred distinctions are drawn between income and estate and gift taxes. In general, income taxes apply to calendar or fiscal year transactions. Historically, this Court has rarely overridden retroactive income tax legislation given the Government's paramount interest in securing operating revenues and in apportioning governmental operating costs among those protected. It is thought that a taxpayer subject to the application of retroactive income tax laws would have received the income without regard to the presence or absence of the retroactive legislation and accordingly cannot be considered to have been "surprised" by the retroactive legislation. Thus, statutes taxing all income received during a calendar year have been sustained even though enacted during the latter part of the year. *See, e.g., Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 20 (1916); *Stockdale v. Atlantic Ins. Co.*, 87 U.S. (20 Wall.) 323 (1874); cf. *Cooper v. United States*, 280 U.S. 409 (1930); *Lynch v. Hornby*, 247 U.S. 339 (1918). Moreover, even if pre-enactment conduct could have been altered had the taxpayer had notice of the proposed legislation, retroactive income tax legislation has been constitutionally validated. *United States v. Darusmont*, 449 U.S. 292 (1981). The same rationale has historically not been applicable to estate and gift taxes.

As to the estate tax, a death transfer tax requires a creation of a balance sheet reflecting the value of assets owned at death and interests transferred in certain ways to others before death. *See, e.g.*, 26 U.S.C. (1970 ed.) 2035 (Transfers in Contemplation of Death), 2036 (Transfers With a Retained Life Estate), 2037 (Transfers Taking Effect at Death), and 2038 (Revocable Transfers). As new and different ways of retaining strings with respect to or otherwise controlling wealth are spawned outside the then existing legislative nets, Congressional responses are required.[24] Moreover, as to the element of surprise: the

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[24] In *United States* v. *Byrum*, 408 U.S. 125, *reh. denied*, 409 U.S. 898 (1972), the decedent, a 71 percent shareholder in three related corporations, transferred a portion of his stock in each corporation to a trust which he established for the benefit of his children. Although the independent trustee was granted discretion to control the trust property for the sole benefit of the beneficiaries, Mr. Byrum reserved the rights to vote the stock of the corporation, veto the sale of the stock, and replace the trustee.

While conceding that the retention of voting rights in an "unimportant minority interest" would not produce any tax under 26 U.S.C. (1970 ed.) 2036 or 2038, the Government argued that the cumulative effect of the retained powers left the decedent with absolute control of the corporations which was the equivalent of "possession and enjoyment" of the transferred stock, within the meaning of 26 U.S.C. (1970 ed) 2036(a)(1). As retained control left Mr. Byrum with power to control the income flow, he retained a power to "designate . . . who shall possess or enjoy the property or the income therefrom" under 26 U.S.C. (1970 ed) 2036(a)(2), and power to affect "the enjoyment" of the property under 26 U.S.C. (1970 ed) 2038(a)(1). This Court held that the retained powers were essentially "administrative" not "dispositive" or of sufficient "present economic benefit" to come within the pale of 26 U.S.C. (1970 ed) 2036 or 26 U.S.C. 2038.

The Congressional response: 26 U.S.C. 2036(a)(1). The Committee Reports specify that the amendment to 26 U.S.C. (1970 ed) 2036(a) is in response to the *Byrum* decision. See H. Rep. 94-1380, *supra*.

prospective decedent still has some, though perhaps little time, within which to manage or rearrange his financial affairs. As to the desire to have reasonable certainty as to past transactions: the estate tax, from its inception, has operated upon death bed circumstances.

As to the gift tax, the otherwise paramount revenue collecting interest of the government should be placed at least on an equal footing with that of the individual's need to know the consequences of the individual's proposed act before the act is committed. Individuals are free to contract against income tax changes: both contracting parties are at least alive and able to renegotiate positions. Changes in the estate tax are less subject to alternative plans but nonetheless may be planned for or against. But retroactive gift tax laws are the worst of the breed: once an individual has made the gift, the individual may not renegotiate the gift or plan around it. The transaction is, by definition, irrevocable. Congress[25] and this Court have traditionally

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[25] The application of gift tax legislation to completed transactions has been regularly avoided by Congress. The gift tax included by the Act of 1932, Section 501, 47 Stat. 245, was made specifically inapplicable "to a transfer made on or before the date of the enactment of this Act," Section 501(b) (the Act was passed on June 6, 1932). The change in rates provided by the Act of 1934, Section 520(a), 48 Stat. 761, 26 U.S.C.A. § 1136(b), applied only to calendar years beginning with 1935, though given the cumulative nature of the tax, computations must be made as if the new rates were applicable during prior years. The Internal Revenue Code of 1954 applied only to gifts made after December 31, 1954. Section 2501, 26 U.S.C. Finally, new 26 U.S.C. 2010(c) applies to gifts made after September 8, 1976, the date the Conference Committee approved the transitional rule as eventually enacted but before the date the President signed the legislation on October 4, 1976.

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required that retroactivity be avoided, if possible. *Blodgett v. Holden*, 275 U.S. 142 (1927), modified, 276 U.S. 594 (1928); *Untermyer v. Anderson*, 276 U.S. 440 (1928). At least one commentator has painted the backdrop against which retroactive legislation should be tested.[26]

Notwithstanding the Government's assertion that the application of the constitutionally permissible retroactivity doctrine controls the disposition of this case, in none of the principal cases cited by the appellant was the issue in this case squarely faced: 26 U.S.C. 2010(c), as applied to this transaction, is so arbitrary and capricious as to render it unconstitutional because Mr. Hirschi's estate is penalized for Mr. Hirschi's attempt to obtain a legislatively provided tax benefit. Mr. Hirschi was offered an election which permitted him to make the $30,000 gifts tax free. Under no construction of that legislation could Mr. Hirschi be presumed to know that if he availed himself of that otherwise beneficial election and then died within the period which would cause the gifts to be included in his estate for estate tax purposes, would he not only forfeit the election claimed but be penalized by the shrinkage of his unified credit to the extent of $6,000. None of the cases deal with an election conferred, then taken, and substituted with a penalty, retroactively applied for up to three years.

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All events occurred with respect to the Hirschi gifts—the gifts were irrevocably made on September 28, 1976 and the gift tax return was filed as required which indicated no tax due (J. S. App. 2a-3a; J. A. 5, 8-13), before the date of enactment though the bill had passed both Houses of Congress on September 16, 1976.

[26] Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 697 (1960).

C. The Application of the 1976 Act to The Hirschi Estate Does Deprive Appellees of Property.

The Government contends that if the provisions of the estate tax as it stood in September, 1976 had been applied to Mr. Hirschi's estate, the tax would have been $655.16 more than the tax paid by the estate under the Act. Thus, the Government argues that Mr. Hirschi's estate paid $655.16 less in tax by reason of the applicability of the Act, and accordingly has not been deprived of property. The Government's argument fails to consider the increase of $6,000 in taxes payable by the estate due to reduction of the unified credit. The $6,000 reduction in the unified credit has the same effect as the imposition of an additional tax of $6,000. *Cf. Regan v. Taxation with Representation*, 461 U.S. 540, 544 (1983). Moreover, the Act was intended to reduce estate taxes by from ten to fifteen percent. *See* n. 4, *supra*. Application of Section 2010(c) deprives Mr. Hirschi's estate of the tax reduction which the Act was intended to effect.

D. Even if Congress Provided Timely Notice of the Transitional Rule That It Enacted, the Notice Which It Provided Constituted An Unconstitutional Trap for the Wary.

Mr. Hirschi irrevocably gifted his property on September 28, 1976, after the House Ways and Means Committee approved its version of the transitional rule on August 6, 1976, after the Conference Committee approved the version which was eventually enacted, after the bill passed both houses of Congress on September 16, 1976, but before it was signed by the President on October 4, 1976. As applied to Mr. Hirschi, the Act did not alter the tax treatment of a gift which was the subject of an existing tax

(*cf. Milliken v. United States*, 283 U.S. 15 (1931)), but rather subjected to tax Mr. Hirschi's claim to the specific exemption, which would not have been the subject of any tax under prior law. Thus, the transaction should be governed by *Untermyer v. Anderson*, 276 U.S. 440 (1928) and *Blodgett v. Holden*, 275 U.S. 142 (1927), modified, 276 U.S. 594 (1928), which hold that gifts made before enactment are beyond the reach of a retroactive statute.

Assuming the transitional rule was adopted to prevent a "rush to the door" by prospective donors seeking to circumvent the accomplishment of the purpose of the legislation as in *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, No. 83-245 (June 18, 1984), slip op., the House Committee report failed to apprise Mr. Hirschi of the possible forfeiture of $6,000 of his unified credit if he proceeded. Moreover, if the loss of $6,000 of Mr. Hirschi's credit *and* the imposition of more tax was anticipated by Congress, then the House report was defective in that it suggested just the contrary: that he or his estate would benefit from his claim to his specific exemption. If Mr. Hirschi is to be charged with constructive notice of the pending congressional action, then at least the Committee Report (H.R. Rep. 94-1380, *supra*) should not have suggested that he claim his specific exemption, as not to do so would result in a loss of a benefit, instead the report should have cautioned against the imposition of an additional tax. The situation in which Appellees find themselves is, at the very least, "inequitable" and the inequity stems not from the fact of human mortality or from a flawed reading of the Internal Revenue Code, but from the interpretation proposed by the Government. If Congress had intended the result urged by the

Government, then adequate warning should have been given.

If, as contended by the Government, Mr. Hirschi should have "waited a week to see if the President signed the 1976 Act, and then computed the relative advantages and disadvantages of *claiming* the exemption in view of the uncertainties of life." (Government's Brief, p. 17) (emphasis supplied), and if the Committee reports "provided him with constructive notice of what the effect of claiming the specific exemption was very likely to be," (Government's Brief, p. 24), then he would have assumed that by claiming his specific exemption, he or his estate would, in some way, "benefit". With a view toward correctly assessing the relative advantages and disadvantages of claiming the exemption, Mr. Hirschi would have been obliged to perform one more act, within the due date of his third quarter of 1976 gift tax return. Die. Mr. Hirschi would have had to die within the period in order for his estate to determine if Mr. Hirschi should or should not claim his specific exemption. The situation in which Appellees find themselves is, at the very least, "inequitable" and the inequity stems not from the fact of human mortality or from a flawed reading of the Internal Revenue Code, but from the interpretation proposed by the Government.

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CONCLUSION

The judgment of the district court should be affirmed.

Respectfully submitted,

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